

Franchise Tax Board**ANALYSIS OF AMENDED BILL**

Author: Wolk Analyst: Jahna Alvarado Bill Number: SB 342
Related Bills: See Legislative History Telephone: 845-5683 Amended Dates: April 25, 2011 and May 4, 2011
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Bar Contingent Fee Arrangements For Matters Governed By R&TC/ R&TC Exclusive Means For Award Of Attorney Fees

SUMMARY

This bill would prohibit contingent fee payment structures with regard to matters governed by the Revenue and Taxation Code (R&TC) and would establish a provision in the R&TC as the sole means for determining reasonable attorney fees that could be awarded to a prevailing party in tax litigation.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Amendments

The April 25, 2011, amendments removed the bill's existing provisions regarding Voluntary Compliance Initiative 2 and amended in the provisions discussed in this analysis.

The May 4, 2011, amendments modified the language that would prohibit contingent fee payment structures.

This is the department's first analysis of this bill.

Summary of Suggested Amendments

Amendments 1 through 4 are provided to resolve the technical considerations regarding clarity, consistency of terminology, and drafting style.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to eliminate the incentive for unregulated consultants to promote aggressive positions on tax returns on a contingency fee basis. This bill would also clarify a drafting error from 1983 when the state intended to conform to federal law which required all attorneys' fees related to tax cases to be awarded under the R&TC.

Board Position:	Executive Officer	Date
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EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2012, and would specifically apply to fee arrangements entered into or court proceedings brought on or after the effective date of this bill.

The legislative intent language specifies that no inference shall be drawn with respect to the amendments this bill would make to R&TC section 19777 for any court proceeding brought before the bill's effective date.

ANALYSIS

FEDERAL/STATE LAW

Federal law allows the Secretary of the Treasury to regulate the practice of practitioners before the Internal Revenue Service (IRS). IRS Circular 230 generally spells out requirements for these practitioners, and also regulates the conduct of anyone providing tax advice or preparing tax returns for compensation, including attorneys, certified public accountants, and enrolled agents. In 2009, the IRS revised Circular 230 to bar individuals practicing before the IRS from charging clients contingency fees for services rendered in connection with any matter before the Internal Revenue Service, including the preparation or filing of a tax return, amended tax return or claim for refund or credit, with specified exceptions.¹

State law restricts commissions charged by certified public accountants in specified circumstances.²

Under the Internal Revenue Code (IRC), parties that prevail against the IRS may be awarded reasonable litigation costs.³ To receive attorney fees, a prevailing party must meet three requirements:

- (1) have exhausted all available administrative remedies prior to initiating the lawsuit;
- (2) have reasonable litigation costs allocable solely to the United States; and
- (3) have reasonable litigation costs during the court proceeding, except for the period in which the prevailing party has unreasonably protracted that proceeding.

¹ The final regulations permit a practitioner to charge a contingent fee for services rendered in connection with the IRS examination of, or challenge, to (i) an original tax return, or (ii) an amended return or claim for refund or credit when the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return. Contingent fees are also permitted for interest and penalty reviews and for services rendered in connection with a judicial proceeding arising under the Internal Revenue Code. The final amendments to section 10.27 made by the final regulations apply to fee arrangements entered into after March 26, 2008.

² Business and Professions Code section 5061.

³ Internal Revenue Code section 7430(c)(1).

Reasonable litigation costs include court costs, expert witness fees, the cost of studies, and attorney fees. The hourly rate for attorney fees is capped. The cap is adjusted each calendar year using a statutory cost-of-living rate. The rate for calendar year 2011 is \$180 per hour.⁴ A court may award attorney fees above the capped rate when a special factor presents itself. The statutory examples of special factors include the following: the availability of qualified attorneys for the type of case, the difficulty of the case, and the local availability of tax attorneys. To be considered a prevailing party, the party must substantially prevail on the disputed amount, or substantially prevail on the significant issues in the case. The IRC contains a net worth requirement that is not found in the R&TC. Under the IRC, to qualify for the award, an individual's net worth may not exceed \$2,000,000, and a business may not have a net worth over \$7,000,000 and over 500 employees. However, if the IRS establishes that its position was substantially justified, then the prevailing party may not recover any attorney fees or litigation costs. To be substantially justified, the IRS's position must have a reasonable basis in law and fact. It does not need to be a winning argument. The provisions of the IRC with respect to the award of attorney fees are the exclusive basis upon which attorney fees may be awarded in tax-related litigation in federal court.

The California Constitution prohibits a state agency from doing any of the following⁵:

1. Declaring a statute unenforceable, or refusing to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional;
2. Declaring a statute unconstitutional; or
3. Declaring a statute unenforceable, or refusing to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

Current state law provides two methods for determining attorney fees in tax related cases: the R&TC which caps attorney fees at an hourly rate, and the Code of Civil Procedure (CCP), which uses a multiplier to determine attorney fees.

The R&TC provides that certain parties that prevail against the Franchise Tax Board (FTB) in a civil proceeding may be awarded reasonable litigation costs, defined to include court costs, expert witness fees, the cost of studies, and attorney fees. To receive attorney fees, a prevailing party must meet three requirements:

1. have exhausted all available administrative remedies prior to initiating the lawsuit;
2. have reasonable litigation costs allocable solely to the State of California; and
3. have reasonable litigation costs during the civil proceeding, except for the period in which the prevailing party has unreasonably protracted that proceeding.

⁴Rev. Proc. 2010-40, 2010-46 IRB 663.

⁵ Cal. Const., Art. 3, section 3.5.

The hourly rate for attorney fees is capped and adjusted each calendar year using a statutory cost-of-living rate. The rate for calendar year 2011 is \$160 per hour. A court may award attorney fees above the capped rate when a special factor presents itself. The statutory examples of special factors are:

1. The availability of qualified attorneys for the type of case;
2. The difficulty of the case; and
3. The local availability of tax attorneys.

To be considered a prevailing party, the party must substantially prevail on the disputed amount, or substantially prevail on the significant issues in the case. However, if the State of California establishes that its position was substantially justified, then the prevailing party may not recover any litigation costs. To be substantially justified, the state's position must have a reasonable basis in law and fact. It does not need to be a winning argument.

Under the CCP, a prevailing party whose litigation results in the enforcement of an important public interest may be awarded attorney fees. To receive attorney fees a party must meet three requirements:

1. Provide a significant benefit to the general public;
2. Have a financial burden that makes the attorney fee award appropriate; and
3. To achieve justice the circumstances require that attorney fees be provided in addition to the recovery.

A financial burden that makes an award appropriate is one where the cost of victory exceeds the party's personal interest so that the cost of the lawsuit is disproportionate to the disputed issue. A court may award less than the full amount of attorney fees when a successful party's financial gain warrants. Public entities may not receive attorney fees in litigation against individuals.

Attorney fees are calculated by determining the lodestar and applying a multiplier. The lodestar is the product of the hours the attorney worked multiplied by a reasonable hourly rate. The trial court may increase or decrease the lodestar by a multiplier. For example, if an attorney worked ten hours at a reasonable hourly rate of \$350, then the lodestar is \$3,500. If a multiplier of 2 is applied, the final attorney fees awarded are \$7,000.

Unlike the R&TC section, the CCP and the Private Attorney General Doctrine⁶ do not require the exhaustion of administrative remedies and allow an award of attorney fees even if the defendant (here the FTB) was substantially justified in defending the lawsuit.

⁶ The "Private Attorney General" Doctrine. In 1974, the United States Court of Appeals for the District of Columbia awarded the Wilderness Society, Environmental Defense Fund, and Friends of the Earth attorney fees for serving as a private attorney general. The attorney fees were sought for the plaintiff's litigation to prevent construction of an Alaskan pipeline. The Court of Appeals found that the plaintiffs acted as a private attorney general by enforcing public policy and should not have to finance litigation that was for a public benefit. The fee shifting was not intended to be punitive. In 1975, the United States Supreme Court reversed the decision in *Alaska Pipeline Serv. Co. v. Wilderness Soc'y* because the Court of Appeals awarded the attorney fees without a statutory basis and because this award was contrary to "the general 'American rule' that the prevailing party may not recover attorneys' fees as costs or otherwise." The Supreme Court in this case also stated that it was within the authority of Congress to create a private attorney general doctrine.

THIS BILL

This bill would prohibit the use of contingent fees for services rendered for any matter before the State Board of Equalization (BOE), the FTB, any assessment appeals board, or for any other matter involving a tax imposed under the R&TC and would impose a penalty equal to the greater of \$5,000 or the amount of the contingent fee charged for violating the prohibition. The penalty would be payable, upon notice and demand, to the agency responsible for administering the tax underlying the contingent fee arrangement, regardless of whether any or all of the fee had been actually paid to or received by, directly or indirectly, the person subject to the penalty.

A penalty imposed by the FTB for violating the prohibition against contingent fees is not subject to protest or appeal prior to payment.

In addition to imposing a penalty, this bill would do all of the following with respect to prohibited contingent fees:

- Declare that contingent fees for services as defined under this bill are against public policy and any contract or agreement for contingent fees in these matters is void and unenforceable.
- Authorize the BOE or the FTB to require a person rendering services as specified to provide, upon request, written certification under penalty of perjury that the fee for their services does not include, in whole or in part, any contingent fee.
- Authorize BOE and FTB to adopt standards, criteria, procedures, rules, and instructions, exempt from the requirements of the Administrative Procedure Act, to prevent the use of contingent fee arrangements.

This bill would specify that the R&TC section is the exclusive attorney fee remedy for a party that prevails in a law suit against the FTB and would make several technical, non-substantive changes to the provision regarding the award of reasonable litigation costs to a prevailing party.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is working with the author's office to resolve these and other concerns that may be identified.

This bill lacks administrative details with regard to the penalty that a person that charges a contingent fee would be required to pay. For example, how would a governmental entity become aware of a prohibited contingent fee without undertaking an examination? Would a governmental entity be required to perform examinations to discover prohibited contingent fee situations?

TECHNICAL CONSIDERATIONS

Subdivisions (a) and (b) of Section 41 need to be amended to replace the term "the State Board of Equalization" with "the board" to correspond to the definition in Section 20 of the Revenue and Taxation Code. Amendments 1 and 2 are provided to make this change.

The penalty language contained in subdivision (c) of Section 41 is not clearly worded. Amendment 3 is provided to clarify that the existence of a contingent fee arrangement would subject a tax professional to the penalty, irrespective of the status of payment of the contingent fee.

Subdivision (h) of Section 41 needs to be amended to replace the term "applies" with "shall apply" to correspond to the current style for drafting legislation. Amendment 4 is provided to make this change.

LEGISLATIVE HISTORY

SB 813 (Chapter 498, Stats. 1983) among other things:

- Originally enacted the penalty for the understatement of a taxpayer's liability by a tax preparer as R&TC sections 18684.6 and 25934.6, effective for returns filed for taxable years beginning on or after January 1, 1983. These sections were subsequently consolidated as R&TC section 19166. The penalty is the greater of \$5,000 or 50 percent of the income derived or to be derived by the tax return preparer with regard to the return or the claim.
- Originally enacted the penalty for promoting abusive tax shelters as sections 19415 and 25957, effective July 28, 1983. These sections were subsequently consolidated as R&TC section 19177. The penalty is the lesser of \$1,000 or 100 percent of gross income derived (or to be derived) from the promotion of abusive tax shelters. If an activity for which the promoter penalty is imposed includes a false or fraudulent statement, the penalty is 50 percent of the gross income the promoter derived (or to be derived) from promoting the tax shelter.
- Originally enacted provisions awarding reasonable litigation fees to a prevailing party, as specified, as R&TC sections 19420 and 26491, effective for proceedings that commenced on or after July 28, 1983. These sections were subsequently consolidated as R&TC section 19717

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Review of *Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable law with regard to the prohibition of contingent fees for tax matters.

With regard to the attorneys' fee provision, none of these states have an Equal Access to Justice Act (EAJA) as broad and encompassing as California's private attorney general doctrine as codified in CCP section 1021.5. Nor do they have a private attorney general act as broad and encompassing as California's. *Florida* has a private attorney general provision in Florida Statute section 400.023. The statute pertains to the rights of those in nursing homes and related health care facilities. Recovery of costs and reasonable attorney fees not to exceed \$25,000 are available to parties who prevail in seeking injunctive relief or an administrative remedy.

Under *Florida* law, a prevailing taxpayer may be awarded attorney fees and litigation costs when the tax agency's position is not substantially justified. The statute does not state it is an exclusive remedy. Under the Florida EAJA, a qualifying party may recover attorney fees and litigation costs resulting from adjudicatory proceedings or administrative proceedings. In an action initiated by the state, an award for attorney fees and costs may not exceed \$50,000.

Illinois, *Massachusetts*, and *Minnesota* law have no equivalent mention of attorney fee and litigation cost recovery in the tax code. *Illinois* and *Massachusetts* law does not contain an EAJA type act. *Minnesota* law contains a provision similar to the federal EAJA. It permits a prevailing party in a civil proceeding with the state to recover fees and other expenses if the party shows the state's position was not substantially justified. The act includes attorney fee awards in tax cases. *Michigan* law permits a taxpayer to recover actual damages, which include attorney fees, up to \$10,000 when the tax agency intentionally or recklessly ignores a rule, guideline, procedure, or the law. *Michigan* does not have an EAJA-type act.

Of these states, *New York* most closely mirrors the IRC model of serving as the sole remedy in awarding attorney fees and litigation costs to certain prevailing parties in tax disputes. New York Tax Law section 3030 provides that certain parties that prevail against the Department of Taxation and Finance in a civil proceeding may be awarded reasonable litigation costs.

Reasonable litigation costs include court costs, expert witness fees, the cost of studies, and attorneys' fees. The hourly rate for attorneys' fees is capped. The court may adjust the rate upon a determination that there is an increase in the cost of living. The statutory rate is \$75 per hour. A court may award attorneys' fees above the capped rate when a special factor presents itself. The statutory example of a special factor is the limited availability of qualified attorneys for such proceedings. To be considered a prevailing party, the party must substantially prevail on the disputed amount or substantially prevail on the significant issues in the case. However, if the tax agency establishes that its position was substantially justified, then the prevailing party may not recover any litigation costs.

The statute is the exclusive remedy for a prevailing party to be awarded litigation costs and attorney fees in connection with the determination, collection, or refund of any tax. New York has an EAJA, but it is not applicable to tax cases because the tax law provides an exclusive remedy.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

This bill may result in some departmental savings of administrative costs resulting from reduced litigation expenses because awards under CCP section 1021.5 would not be permitted. The amount that may be saved is speculative because there have been few awards made under CCP section 1021.5, and this bill would not impact those earlier cases.

ECONOMIC IMPACT

Prohibition on Contingent Fees

Because of the deterrents contained in this bill, penalty revenue is expected to be minor. Some penalties would be assessed after enactment but would decline quickly in subsequent years as taxpayers and tax preparers become aware of the new law.

The expected decrease in claims filed and increase in penalty revenue would result in revenue gains on the order of magnitude of \$8 million annually.

Attorneys Fees Awarded to Prevailing Party: Revenue & Taxation Code (R&TC) Section 19717 the Sole Remedy

This proposal could reduce state expenditures by preventing attorneys who successfully sue the FTB from receiving certain types of fee reimbursements. The amount of this savings is unknown because it depends on the frequency of relevant litigation and on the size of future awards. Because this proposal only applies to future litigation and there is typically three to four years between the date litigation is filed and the date an award for litigation costs is paid, no impact is expected until 2015.

In August 2006, for the first time, a prevailing party in litigation with the FTB was awarded attorney's fees under CCP section 1021.5. The lower court awarded fees of \$3,500,000. This single award was \$3,300,000 more than the "reasonable fees" allowable under R&TC section 19717. After appeal and remand, the court arrived at a CCP section 1021.5 award of just under \$1,800,000, or \$1,600,000 more than the "reasonable fees" under R&TC section 19717. Because any amount actually paid by the state is taxable to the recipient, the cost to the state would be reduced by the recipient's marginal tax rate of approximately 9.3 percent.

The FTB currently has three cases in litigation involving attorney fees being awarded under CCP section 1021.5. Data to estimate the potential cost to the state for these three cases are unavailable.

Department staff has identified an additional nine cases currently in litigation that could result in attorney fees being awarded under CCP section 1021.5. There is no way to ascertain which, or how many, of these nine cases the FTB will lose and how many of the prevailing private attorneys would seek an award of fees under CCP section 1021.5.

SUPPORT/OPPOSITION⁷

Support: Franchise Tax Board (attorney fee portion).

Opposition: Unknown.

ARGUMENTS

Pro: Proponents of this bill may argue that prohibiting contingent fee arrangements and limiting the award of attorney's fees in litigation against the FTB would reduce the incentive to pursue overly aggressive positions with regard to certain tax matters.

Con: Opponents of this bill may argue that fees arrangements for professional tax services should be the decision of the parties involved and attorney's fees decisions are best left to the court, and neither should be dictated by the Legislature.

POLICY CONCERNS

The California Constitution requires a state agency to enforce a statute without regard to the issue of constitutionality until an appellate court determines the statute unconstitutional.⁸ Consequently, FTB must enforce a statutory provision of the R&TC without regard to the constitutionality of that statute, which subjects the state to possible significant awards for attorneys' fees if CCP section 1021.5 applies to tax refund litigation.

Congress made the policy decision in 1982 in TEFRA section 292 to make the IRC the exclusive statutory authority for award of attorneys' fees in tax litigation against the federal government and thus to except tax litigation from the incentive aspect of the EAJA. Additionally, the policy determinations that (1) subsidizing a prevailing taxpayer should be limited because the source of the funds paid to the prevailing taxpayer is other taxpayers, and (2) a taxpayer should not be relieved of 100 percent of the economic risk of their tax litigation, is reflected in the limitation on eligibility for reimbursement and the maximum rate for reimbursement.

LEGISLATIVE STAFF CONTACT

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⁷ As reported by the Senate Governance and Finance Committee Analysis dated April 21, 2011 at http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0301-0350/sb_342_cfa_20110421_154508_sen_comm.html [as of September 29, 2011].

⁸ Cal. Const. Art. III section 3.5.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 342
AS AMENDED APRIL 25, 2011

AMENDMENT 1

On page 2, line 5, strikeout "State Board of Equalization" and insert:

board

AMENDMENT 2

On page 2, line 11, strikeout "State Board of Equalization" and insert:

board

AMENDMENT 3

On page 3, line 8, strikeout "paid or otherwise received" and insert:

paid to or received

AMENDMENT 4

On page 4, line 2, strikeout "applies" and insert:

shall apply